# Market Segment Specialization Program

# Retail Gift Shops

**Training 3123-016 (6-01)**
**TPDS No. 87069J**

# Retail Gift Shops

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# Introduction

## STATEMENT OF PURPOSE

Use this Audit Technique Guide (ATG) during all phases of the examination.  The purpose of this guide is to:

- Provide information about the retail gift shop market segment
- Identify frequent and/or unique issues
- Provide examination techniques
- Supply applicable tax law and court cases

## OBJECTIVE

Upon completion of this audit technique guide, the examiner will be able to:

- Identify and develop issues specific to the retail gift shop market segment
- Conduct an examination consistent with other market segment examinations throughout the Service

# Chapter 1
# Market Segment Definition and Overview

## DEFINITION

The retail gift shop industry includes numerous entities of various sizes that are engaged in the business of selling gifts, cutlery, cookware, novelties, watches, wearable art, decorative accessories as well as seasonal (for example, Christmas), commemorative, specialty and collectible items.

## BACKGROUND

The gift giving industry generally benefits from a healthy economy in which consumers have disposable income available to spend on non-essential consumer goods. As a result, there have been new entrants into the industry including:

1. individuals who have worked extensively as employees in the retail gift shop industry who begin their own business,
2. hobbies that evolve into businesses and
3. Retirees who begin their own business.

A leading research company estimated that U.S. retail sales of giftware have risen to $20.9 billion last year, and will continue to increase annually. However, geographic location seems to have substantial impact on profitability (high tourist areas seem to be the most profitable).

## Current Status

- **Unique Business Practices:**
    - Gift shop owners usually attend a minimum of two trade shows each year. The largest trade show is an ongoing one located in Atlanta, Georgia; others are held in Chicago, San Francisco, Dallas, Las Vegas, and New York. Some acquire merchandise directly from foreign manufacturers.
    - Some independently owned shops expand rapidly without proper financial planning resulting in out of balance ratios (for example, debt to equity)
    - Some gift shops receive various rebates and vendor allowances. See this section of the ATG (Chapter 2)

- **Form of Business**: All forms of business are used: sole proprietorship, LLC, partnership, C Corporation and S Corporation.

- **Ownership Forms**: Regardless of business form, most gift shops are family owned and operated.

- **Sources of Revenue**: Gross receipts are generated from the sale of merchandise: china, cutlery, cookware, sculptures, figurines, novelties, watches, wearable art, decorative accessories as well as seasonal (for example, Christmas), commemorative, specialty and collectible items and novelty crafts e.g. quilts, lace linens, antique items, etc.

- **Locations**: shopping centers (both strip malls and indoor malls); single unit buildings, tourist areas, specialty areas (e.g. historic districts)

- **Books and records**: various, including no "formal" set of books; single entry; full double entry

- **Gross Receipts**: From $700 to $6 million,

- **Consolidating Trends: Many** businesses start as small one store operations and expand into multi-state, multi-store operations and from sole proprietorships to incorporated forms of business.

- **Industry Publications & Sources**

  Giftware Business, a monthly magazine
  600 Harrison Street
  San Francisco, California

  Giftware News, a monthly magazine
  20 N. Wacker, Suite 1865
  Chicago, Illinois 60606

  Web Sites:
  http://www.giftwarnews.net
  http://www.collectiblenews.com

# Chapter 2
# Issues

## METHOD OF ACCOUNTING

In general, an accounting method is a set of rules used to determine when and how income and expenses are reported. With the filing of the taxpayer's first tax return, the taxpayer's method of accounting is established.

There are two overall methods of accounting according to IRC section 446(c) and the regulations thereunder – the cash receipts and disbursements methods and an accrual method. In practical terms there is a third method, the hybrid method.

1. **Accrual** – Income is reported when it is earned. Expenses are reported when incurred but not necessarily paid.
2. **Cash** – Income is reported when it is actually or constructively received. Expenses are reported as paid.
3. **Hybrid** – Is a combination of overall methods and/or other special methods for specific items. For example, a taxpayer may report income and certain costs (inventory) using the accrual basis while other expenses are reported using the cash basis of accounting (Treas. Reg. section 1.446-1( c )(1)(iv)).

A taxpayer is required to compute taxable income in accordance with the method of accounting, which the taxpayer regularly uses to compute book income, if that method clearly reflects income. Items of income and deductions must be treated consistently from year to year under the taxpayer's method of accounting in order for that method to clearly reflect income. If the method employed by the taxpayer does not clearly reflect income, the Commissioner has the authority to require a taxpayer to change to an accounting method, that does clearly reflect income. This does not, however, justify any arbitrary requirement of change. If the accounting method used by a taxpayer's books clearly reflects income, the Service may not determine income by another method, which would also clearly reflect income.

Gift shop income, obviously, is generated by the sale of merchandise inventory. Therefore, per Treas. Reg. section 1.446-1(c)(2)(i), a gift shop taxpayer will be required to use the accrual basis of accounting for income and expenses with regard to inventory. ***Boynton v. Pedrick***, [56-1 USTC ¶9126] &, 228 F. 2d 745 (2nd Cir. 1955), ***cert. denied,*** emphasizes the accrual basis requirement when inventories are a part of the business. The case states: "* * * the power of the Commissioner to require the use of inventories in computing income carries with it the power to require the use of a method of accounting in which the use of inventories has substance and meaning."

Under Treas. Reg. section 1.471-1, a taxpayer must use inventories to clearly reflect income whenever the production, purchase, or sale of merchandise is an income-producing factor. Because "merchandise" is not defined in the code or regulations, courts generally will apply the term's ordinary meaning to a taxpayer's facts. ***Wilkinson-Beane, Inc. v. Commissioner***, TCM, [CCH Dec.

29,546(M)] Docket No. 2325-67, 28 TCM 450, TC Memo. 1969-79, Filed April 21, 1969 420 (1st Cir. 1970), (caskets are merchandise because they played a central role in the sale of the taxpayer's funeral services); ***Knight-Rider Newspapers, Inc. v. United States***, (newspapers sold to the public are merchandise). [84-2 USTC ¶9827], 743 F.2d 781, 797 (11th Cir. 1984)

If method of accounting appears to be an issue, please consult Rev. Proc. 97-27, 97-37 and 99-49 and your local Examining Officer's Guide for the latest procedures.

# INVENTORY ACCOUNTING METHODS

Typically, the most valuable asset of a retail gift shop is inventory. These businesses normally spend significant amounts of time and energy managing their inventory. The general ledger account book inventory should be reconciled to the tax inventory and the ending inventory should be checked for reasonableness. Determine how the taxpayer identifies the goods in ending inventory (that is, whether they identify specific items, utilize FIFO or LIFO methods), how the taxpayer values goods in ending inventory (they may use the cost method, the lower of cost or market, or the retail method, all of which are discussed further below), and determine whether these inventory methods are proper and have been consistently used. Please note that any change to correct the taxpayer's method or basis used in the valuation of inventories is a change in its method of accounting subject to the provision of IRC sections 446 and 481.

## Cost Method

Generally, smaller retail gift shops use either the cost method or the lower of cost or market to determine the value of inventory. Larger shops use the retail method.

The cost method simply requires inventory to be valued at its acquisition cost. Examiners should be sure that the inventory valued at cost includes ALL of the costs associated with taking possession of the merchandise, including freight-in charges. Also ensure that the cost has been reduced for any trade discounts received by the shop owner.

Most retail gift shop owners take a physical inventory count at or near the end of the year. Inventory is usually low at this time, as the increased inventory on hand for Christmas has been sold. It is not unusual for a gift shop to sell hundreds of small items so the process of taking a physical inventory can be very time consuming. Many shop owners use pre-printed forms, which contain the names of all items available for sale. When the items are counted, the number in stock is placed beside the name and matched against the stock ledger to determine the cost.

Some smaller shop owners place a code on each item of inventory. The code is usually placed on the bottom of the item. The numeric code normally contains the date the item was placed in inventory, and the cost of the item. (The cost is usually written backwards so as not to make the customer aware). With such a code on each inventory item, the physical inventory process is a bit easier, as it is possible to record each item at cost initially.

## Lower of Cost or Market

Other retail gift shops use the lower of cost or market (LCM) since there are advantages, but no disadvantages, to using the LCM method instead of the cost method. The LCM method is the same as the cost method, as described above, except when the replacement cost of the merchandise drops below the actual cost. If the shop owner is unable to recover his or her cost on the merchandise because the “market” (that is, replacement cost) has fallen below cost, he or she is allowed to recognize that difference even though the loss has not been realized.

Under the lower of cost or market (LCM) method, ”market” generally means replacement cost, that is, the amount it would cost the taxpayer to replace an item if it was bought from the usual source in the usual quantity. See Treas. Reg. section 1.471-4(a). A taxpayer using LCM, may value its inventory at net realizable value only where no open market exists or where quotations are nominal. See Treas. Reg. section 1.471-4(b).

The LCM is not technically a deduction. Instead LCM is a write-down of inventory value that increases cost of goods and reduces gross income. Inventory value may be net of inventory and reserve accounts.

It is determined on an item by item basis. The taxpayer will usually have a separate report computing the LCM, which lists each item, the number on hand plus the cost and market value. The LCM is usually recorded in a separate reserve or contra-asset account rather than directly to inventory.

## Retail Method

Retail gift shops may determine the cost, or the lower of cost or market, by using the retail method. The retail method uses the relationship of retail price to cost to determine the cost of merchandise in inventory. The retail method is an acceptable method used to value inventory.

Examiners should be alert to be sure the following requirements for using this method are met:

1. Inventory must be valued on a department or class of goods basis. This is important because the profit margins may be materially different for each department or class of goods. Treas. Reg. section 1.471-8(c) states that “a taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average for his entire business, but should compute and use in valuing inventory the proper percentages for the respective departments or classes of goods”.
2. The closing inventory must be determined by an actual physical count at least once during a year if not at yearend. The possibility of discrepancies because of total reliance on book inventory (for

example, perpetual inventory systems) is substantial.

3. Ending inventory is required to include all merchandise owned, both on hand as well as in transit.

The retail method assumes that the cost complement, the percentage relationship of merchandise cost to retail, of all purchases is representative of the cost complement of the actual items in ending inventory.

Inventory is usually carried on the books at the retail selling price. The yearend retail price of those goods on hand is reduced by a percentage that approximates either cost or the lower of cost or market, as determined by Treas. Reg. section 1.471-8(a) or (d).

The lower of cost or market generates an inventory which is lower than or equal to that determined by using the cost method, therefore, it is more likely to be employed.

Using the retail method, the lower of cost or market value of the ending inventory is computed in the following steps:

1. Add the cost of the goods in the opening inventory to the cost of the total purchases for the year.

2. Add the retail value of the goods in the opening inventory to the retail value of the total purchases for the year. The retail value in this step must be adjusted to reflect:

   a. The original or initial retail price, as marked up from cost

   b. Plus additional markups, which revise the original retail price

   c. Less markup cancellations, which reduce the additional markups but not below the original retail price.

3. Divide the total cost of the goods available for sale by the total retail value of the goods available for sale during the year. The resulting percentage is the ratio of cost to retail, also known as the cost complement.

4. Subtract sales plus net markdowns from the total retail value of the goods available for sale in (2) above to determine the retail value of the ending inventory.

5. Multiply the retail value of the ending inventory as determined in (4) by the cost complement ratio as determined in (3). The result is the lower of cost or market of the ending inventory

It is important to remember that ending inventory is required to include all merchandise owned, both on hand as well as in transit, and the retail method computations should reflect all year end merchandise in transit.

# CONTRIBUTIONS OF INVENTORY

Seasonal merchandise constitutes a large percentage of the merchandise sold in most retail gift shops. Customers purchase specialty items for Easter, Valentine's Day, Mother's Day, etc. Gift shops stock heavily in anticipation of these special holidays. Immediately after the holiday, the unsold merchandise is usually marked down 50 percent. Merchandise still unsold after 30 days is usually then marked down 75 percent. If the merchandise still does not sell, the retail gift shop owner may donate it to charity.

Under the general rule for charitable contributions of inventory, the deductions are limited to basis by IRC section 170(e)(1)(A). If certain requirements are met, an entity that contributes inventory to be used by the donee solely for the care of the ill, needy, or infants may deduct an amount in excess of the property's basis (enhanced deduction).

There are a number of requirements that a gift shop must comply with for its contribution of an item or group of similar items of inventory property to qualify for the enhanced deduction under IRC section 170 (e)(3). First, the gift shop must be a corporation (other than an S Corporation). Second, the use of the donated property by the donee must be related to the purpose or function constituting the basis for its exemption under IRC section 501. Third, the property cannot be transferred by the donee in exchange for money, other property, or services. Fourth, the gift shop must obtain from the donee a written statement in accordance with Treas. Reg. section 1.170-(4)A(b)(4) representing that the use and disposition of the property will be accordance with IRC sections 170(e)(3)(A)(i) and (ii). Fifth, if the gift shop claims a deduction for its contribution of inventory under IRC section 170(e), it must make a corresponding adjustment to its cost of goods sold by the lesser of the fair market value of the contributed item or the amount of the basis.

Form 8283 must be filed for contributions if the deduction for non-cash gifts is more than $500. If a deduction of more than $5,000 is claimed for an item or group of similar items, Section B of Form 8283 must be completed. Section B generally requires donors to obtain a written appraisal from a qualified appraiser. However, a written appraisal is not required for inventory donated by a C corporation, including a closely held corporation, if the contribution is for the case of the ill, needy, or infants within the meaning of IRC section 170(e)(3)(A).

Treas. Reg. section 1.170A-(c)(3) states that: "If a donor makes a charitable contribution of property, such as stock in trade, at a time when he could not reasonably have expected to realize its usual selling price, the value of the donated item is not the usual selling price, but the amount for which the property would have been sold by the donor at the time of the contribution." This means that, after the holiday, unsold seasonal merchandise is not valued at the pre-holiday price.

# INCOME ISSUES

## Credit and Charge Backs

Often, the retail gift shop determines the amount of the allowance or rebate and issues a purchase credit or charge-back to the vendor. In other instances the vendor sends a notice to the retail gift shop, after the earning period has expired, which reflects the final computation of the rebate monies, possibly accompanied by payment. When amounts are in dispute, the retail gift shop will in most instances shift the burden of proof to the vendor, simply by withholding payment for merchandise purchases.

## Vendor Rebates and Allowances

To the extent that a retail gift shop receives allowances or rebates from vendors after the initial purchase of merchandise and fails to properly account for the allowances or rebates, the retail gift shop may be understating gross profit or improperly reflecting a gross loss on the sale of merchandise. Income from rebates or credits is includible when the right to receive it becomes fixed and certain. In Rev. Rul. 74-607, 1974-2 C.B. 149, the Service ruled that all the events that fix the right to receive income occur on the earliest of when:

1. The required performance takes place
2. Payment is due, and
3. Payment is made

**Target Profit Percentage** - Negotiation of the terms of the purchase of merchandise is a major aspect of the position of buyer for a retail gift shop. The buyer is responsible for assuring that the merchandise to be acquired can be sold at a retail price, which will generate the targeted profit percentage. Some retail gift shops desire a no frills purchase for the lowest possible price. In most transactions, however, there are numerous incentive allowances or rebates offered or demanded as part of the overall negotiated price. These allowances may initially result in a higher purchase price for the merchandise ordered, but the retail gift shop expects that this higher initial cost will be more than offset by the allowances. The details of the negotiated agreement will either be entered into the product data records or maintained by the retail gift shop. It is obviously in the best interest of the retail gift shop to monitor its progress in earning incentive allowances and rebates to ensure that all potential recoveries are earned.

Generally a contractual relationship will be established between the retail gift shop and the vendor. This relationship can be evidenced by a formal contract or terms described in a letter, memo, or other less formal correspondence.

Some of the more common vendor allowances and rebates are as follows:

1. **Volume Discount**. The retail gift shop earns money when the quantity in terms of items or dollars of purchases relating either to specific products or all products exceeds certain levels. For

example, the retail gift shop may earn a recovery equal to one percent of total purchases when the total purchases reach 103 percent of last year's total.

2. **Advertising Allowance**. This allowance also is based upon volume of purchases. The retail gift shop generally does not have to submit advertising documentation or verification to receive this type of allowance, unlike cooperative advertising. It is not unusual for retail gift shops to negotiate agreements to receive both types.

3. **Cooperative Advertising**. In cooperative advertising, a portion of the taxpayer's advertising costs is borne by certain vendors in accordance with cooperative advertising offers of the vendors. It is industry practice for many large vendors to open their cooperative advertising allowance program to most customers. Allowances from some vendors will be limited to a percentage of purchases, which will vary from vendor to vendor, and will sometimes fluctuate according to the volume of purchases. Other allowances may be negotiated between the vendors and the taxpayer's buyers or advertising department personnel. Such agreements generally stipulate the advertising media to be used, conditions relative to the advertising as to the specific product, vendor's name and logo usage, when the advertising is to be performed, size or length of ad, and the amount to be paid or credited to the retail gift shop by the vendor. While it is common for vendors to make the rebate or credit after the retail gift shop submits proof of meeting the required advertising criteria, some vendors make the rebates or credits in advance of the retail gift shop placing the advertising.

   Both the program and negotiated cooperative advertising agreements generally address the retail gift shop's qualification criteria and documentation requirements to be submitted with the retailer gift shop's claims for payment or credit. Qualification requirements will specify the term of the offer, eligibility of the retail gift shop, qualifying merchandise, earned accrual, reimbursement percentage, and art and copy requirements. The documentation of the claim will generally consist of proof of advertising, including tear sheets, and the advertiser's invoice to the taxpayer.

   The retail gift shop's right to the cooperative advertising allowance will generally arise when the a advertising is performed and not at the time documentation is provided to the vendor, or when payment is received by the retail gift shop

   Generally, an accrual method taxpayer that has a right to reimbursement for a portion of its advertising costs by the vendor of the advertised goods, in accordance with a cooperative advertising agreement, accrues the reimbursement under the all events test when the taxpayer places the advertising. There is an early 1991 TAM released that addresses a situation in which cooperative newspaper advertising occurs. It thoroughly discusses applicable law, but cannot be cited as precedent. <u>See</u> I.RC section 6110(j)(3).

4. **Defective Merchandise**. This allowance, usually based on a percentage of purchases, covers the cost of defective merchandise or the handling costs related to it.

5. **Markdown Participation**. Vendors agree to reimburse all or a portion of product markdowns taken

on a specific product, in order to instill confidence in the buyer that the product will perform as predicted.

6. **Shelving or Fixture Allowance**. The vendor may either provide product shelving or money for the purchase of product shelving. For example, a retail gift shop may receive a display case from a vendor on condition that it is strategically placed and used to market the designated product for a certain period of time.

7. **Slotting Allowance**. The vendor desires to have its product displayed in a prominent location, which will help generate sales. The vendor may offer, or the retail gift shop may demand, payment to secure an agreement for specific space.

8. **New Store Allowance**. The vendor may offer free or reduced price merchandise, or non-inventory prize merchandise which would be raffled to store customers, in conjunction with the opening of a new store.

9. **Free Merchandise**. The vendor may have a promotion for a specific time period during which the retail gift shop may receive free merchandise, after purchasing similar merchandise. As an example, for every 100 golf bags purchased, the vendor will provide an additional 10 bags at no extra cost.

10. **Handling Allowance**. The retail gift shop may receive funds from vendors to offset certain costs of handling merchandise, such as the cost of removing ornaments from boxes and placing each item on a shelf.

11. **Holiday Allowance**. Some Vendors allow retail gift shops to retain Holiday merchandise, but reduce the following month's billings by the remaining Holiday inventory. The Holiday inventory is then rebilled the following Holiday Season. This is done for all Holidays, such as Christmas, Easter, Mother's Day and even Halloween.

## Deferred Income - Gift Certificates and Credit Vouchers

Retail Gift Shops may issue gift certificates and credit vouchers. The area of gift certificates and credit vouchers (issued in place of a cash refund) is one where an examiner may find the retail gift shop deferring income beyond the point where it should be reported. Unless the taxpayer elects the deferral rules of Treas. Reg. section 1.451-5, this income must be reported when received.

### Election to Defer Income

If an election is made to defer the income, the general rule for a retail gift shop is that the income from substantial advanced payments must be reported at the earliest of:

1. the time the income is earned under the all events test;

2. the income is recognized under the taxpayer's accounting system, including consolidated financial statements to the shareholders or reports for credit purposes; or

3. the last day of the second taxable year following the year of receipt of a substantial a advance payment-*

*- [Per Treas. Reg. section 1.451-5(c)(3) any payment received pursuant to a gift certificate is a substantial advance payment]

**Approval for Change of Accounting Method**

Treas. Reg. section 1.451-5(e) states that the deferral of income under this section is considered a method of accounting and approval of the Commissioner is required to switch to it.

**Deferral Beyond Second Year**

The most likely situation that will be encountered is where the retail gift shop is deferring the recognition beyond the second year following the receipt of the cash. This might occur due to poor record keeping where no tracking of the outstanding gift certificates is made. However it should be noted that Treas. Reg. section 1.451-5(d) requires the taxpayer to file an information schedule with its return that shows (a) the total amount of advanced payments received in the taxable year; (b) the total amount of advanced payments received in prior years that were included in gross receipts of the current year; and (c) the total amount of advanced payments received in prior years that have yet to be included in income. Thus in order to defer the income in the first place, the taxpayer must maintain some basic records.

**Balance Sheet Liabilities.**

Because the income from gift certificates must be reported no later than it is for book purposes, it is not likely that the examiner will see this on the Schedule M. The examiner is more likely to find this issue on the balance sheet as a liability identified as gift certificates, customer credits or customer deposits. In addition to requesting an explanation or written documentation of their gift certificate issuance and record keeping procedures, the examiner should request samples of the certificates. Most will bear a serial number that will aid in determining how long the certificates have been outstanding. The taxpayer should also have some internal controls to prevent employees from abusing the gift certificates and to prevent counterfeiting. The examiner should get descriptions of these procedures and/or manuals as well as any internal audit or security reports dealing with gift certificates.

**Deferral for Up to Two Years**

Although Treas. Reg. section 1.451-5 allows for the deferral of recognition for up to two years, the examiner must keep in mind that the all events test under Treas. Reg. section 1.451-1 needs to be applied first. Gift certificate income is recognized "when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." The regulations do not permit deferral if the income has already been earned. The examiner should therefore examine the retailer's redemption policy. If no cash refunds are permitted or if the certificates expire before the end of the second year, the income may have to be recognized sooner.

**Treas. Reg. section 1.451-5(c)(1)(iii)**

Because the merchandise for which gift certificates can be redeemed generally is not identifiable until the certificate has actually been redeemed, no deduction is allowed for the cost of the merchandise at the point the income is recognized under Treas. Reg. section 1.451-5(c)(1)(iii). A deduction is allowed only when the merchandise to be redeemed becomes identifiable, that is, when the certificate is actually redeemed. If the certificates are redeemable for either goods or services (for example, at a department store with a retail gift shop) the regulations should still be applicable. Certificates strictly redeemable for services are governed by Rev. Proc. 71-21, which has rules that are very similar.

## Income From Service Related Activities

Many retail gift shop establishments will have departments which are designed to support sales and are not a major source of income or expense to the retail gift shop, which are incidental to the primary business of the store, for example, repair, matting, framing. For instance, some retail gift shops, that sell flowers, will have some method of arranging bouquets for customers. Often these services will be performed in-house by florists.

Methods of detecting services offered include a tour of the facility, or telephoning the sales location and asking what services are available. Accounts of retail gift shops should be analyzed to determine whether the retail gift shop under examination has service departments and, if so, how income and expense is booked. Often, income and expense may be netted into the same account, where a growing credit balance in a balance sheet account may signal an improper deferral of income.

Another area to consider in relation to service departments is how the taxpayer treats them in its cost of sales calculation. Many taxpayers will treat them as a cost of sales for book purposes, and as a period cost for tax. The Service contends that both income and expense should be treated as part of the cost of sales calculation. Prior to the removal of IRC section 453A deferred gross profit in 1986, the difference in treatment was an area of some concern, as the amount of deferred income was directly affected by the gross profit percentage. The issue was addressed in *Marcor, Inc. v. Commissioner*, 89 TC 181 (1987), *nonacq.,* 1990-2 C.B. 1., where it was decided that service department cost was not an item which should be included in cost of sales. However the Commissioner non-acquiesced.

## Promotional Allowances

Promotional allowances are sometimes received before the taxpayer has met all the criteria for earning them. The examiner should apply the all-events test before permitting a deferral of income. Only the unearned portion qualifies for deferral. The examiner should be aware that examination of accounts with titles such as Accounts Receivable Credit Balances or Unearned Promotional Allowances, or which refer to rebates, promotional advertising, bill backs, allowances, discounts, or similar wording are likely to result in adjustments to improperly defer income.

## Prizes and Trips

Retail gift shop owners may receive prizes and/or trips from vendors. Since these types of items fall outside the normal data stream, they are easily omitted from income. Similar situations apply to free merchandise received from vendors as part of promotions. If such transactions are booked at all, they may be run through cost of sales. Interviews with officer/shareholders regarding trips taken, prizes won, meetings attended, etc., can be a productive technique.

## Consignments

Gift shops may receive as well as send out merchandise on consignment. Consignments of merchandise to others to sell are not sales since the title of merchandise remains with the consignor (Treas. Reg. section 1.471-1). It does not matter who holds possession of the merchandise. Therefore, if goods are shipped on consignment, the consignor (Gift Shop Retailer) has no profit or loss until the consignee sells the merchandise. Merchandise that has been shipped out on consignment is included in the consignor’s inventory until it is sold.

Merchandise that is received by the Gift Shop Retailer on consignment is not included in inventory. The profit or commission on merchandise consigned to the Gift Shop Retailer is included in the Gift Shop Retailer’s income when the merchandise is sold. Therefore, include in inventory goods out on consignment. Do not include in inventory goods received on consignment.

Remember to ask the retail gift shop owner if he or she has items OUT on consignment at another location. Gift shop owners often display merchandise at malls, flea markets, and antique shows. Income from these sales should be included in gross receipts.

## Depreciation

A retail gift shop’s fixed assets should be assigned class lives and have depreciation computed using MACRS.

For a general discussion of fixed asset records, refer to the Retail ES&P Guide.

Retail gift shop’s depreciable assets are generally 5-year or 7-year tangible personal property, land improvements, or nonresidential real estate.

5-year property, MACRS asset classes are:
- 57.0 Distributive Trades and Service
- 00.12-Information Systems
- 00.13-Data Handling
- 00.241/00.242-Trucks

7-year property, MACRS asset classes are:
- 00.11-Office Furniture, Fixtures, and Equipment

15-year property, MACRS asset class:
- 00.3- Land Improvements

39-year or 31.5-year property
- Nonresidential real property (building and structural components) placed in service on or after May 13, 1993, has a 39-year recovery period. Nonresidential real property placed in service prior to that date has a 31.5-year recovery period.

Rev. Proc. 87-56, 1987-2 C.B. 674, provides the class lives of property that are used to compute the depreciation allowances under MACRS. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of special assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. If the same item of depreciable property can be described in both and asset category and an activity category, the item should be placed in the asset category. See *Norwest Corporation & Subsidiaries v. Commissioner,* 111 T.C. 105 (1998).

A change to correct a taxpayer’s consistently used improper depreciation method, recovery period, or convention for computing the taxpayer’s depreciation deduction is a change to the taxpayer’s method of accounting, subject to the provisions of sections 446 and 481 of the Code.

## Amortization of Franchises and Trademarks

Some retail gift shops may be purchased under franchise or trademark agreements.

IRC section 197 provides comprehensive rules for the amortization of franchises and trademarks. IRC section197 requires the adjusted basis of an amortizable asset be amortized over a 15-year period.

These provisions were added to the Internal Revenue Code of 1986 by Section 13261 of OBRA 93 and to apply to intangible property acquired after August 10, 1993, or after July 25, 1991, if a valid retroactive election (on a timely filed return) to apply OBRA 93 to intangibles has been made.

**Retroactive Election.** In general, the retroactive election must be made by the due date (including extensions) of the electing retail gift shop’s Federal Income Tax Return for the election year. If however, the retail gift shop’s original Federal Income Tax Return for the election year is filed before

April 14, 1994, the election may be made by amending that return no later than September 12,1994. The retroactive election is made by attaching the election statement to the retail gift shop's original or amended tax return for the election year. In addition, the retail gift shop must amend any previously filed returns when required to do so, as necessary to conform the retail gift shop's treatment required under the intangibles provisions of OBRA 93.

A change to correct a taxpayer's consistently used improper amortization method or recovery period for computing the taxpayer's amortization deduction under Section 197 of the Code is a change to the taxpayer's method of accounting, subject to the provisions of Sections 446 and 481 of the Code. The retroactive election referred to above cannot be made by a request under Section 446(e) of the Code to change the taxpayer's method of accounting.

# Chapter 3
# Examination Techniques

This section covers the techniques specific to examining the issues identified in the previous sections.

## INFORMATION DOCUMENT REQUEST

Shown below are some documents examiners may want to consider when preparing an IDR. Not all of these items should be requested in every case. Examiners should use this information as a guide and request only the items that are appropriate and relevant for their specific case:

- A copy of tax returns for the years 19xx and 19xx
- A copy of the payroll tax returns ( forms 941,940,W-2, and W-3) for the year of examination
- Chart of Accounts
- All worksheets that reconcile the books and records to the tax return
- All paid invoice files for the year under examination
- Copies of any related partnership or corporate returns
- Sales, Cash receipts, purchase, and general journal
- The trial balance including adjusting and closing entries
- Cash register tapes
- All bank statements for the year under examination
- Workpapers supporting the inventory computations
- List of vendors who offer rebates

## INTERVIEW

Shown below are questions to consider asking at the initial interview. Not all of these questions are warranted in every case. Examiners should use them as a guide and ask only those questions that are appropriate for the specific examination.

1. What type of records do you have? (Income, Expense)

2. Who makes the entries?

3. How are gross receipts determined on the tax return?

4. How many cash registers do you have? What brands are they? How many are running at the same time?

5. Who reconciles the register tapes? Have you retained the tapes?

6. How are the cash payouts accounted for?

7. How are over and under amounts from the register reconciliations accounted for?

8. Do you sell lottery tickets? How is your income from this activity determined? Do you maintain daily lottery commission summaries? How is the lottery expense determined?

9. Do you receive income from sources indirectly or unrelated the gift shop sales? (E.g. Rental, Consignments, Repairs, etc.)

10. Do you accept credit cards? Which ones?

11. Do you accept checks? Do you cash checks?

12. How do you record consignment, rental or commission income?

13. What is the markup percentage applied to gift items, crafts, etc.?

14. What percentage of total sales are gift items, crafts, etc.?

15. How does the business identify goods in ending inventory? How does the business value goods in ending inventory?

16. Who are the primary vendors? What are the payment terms? Any Discounts?

17. How do the owners account for any items taken personally?

18. Are gift certificates sold? How are they accounted for (recording, accounts affected on books)

19. Is inventory insurance carried? What is the insured amount?

20. If there are commission expenses or other labor expenses deducted, were 1099's or W-2's filed?

21. Do you send any items out on consignment? If so, How is it recorded?

22. Do you receive vender rebates? If so, what were the various types of allowances and rebates that were negotiated? How were these allowances accounted for on the book as well as the tax return? What accounts were used and what were the accounting entries? How and by whom were they tracked throughout the year? Were they recorded when earned or when paid? What was the magnitude of these rebates?

23. How do you report layaway sales?

24. Do you receive any income for repairs of merchandise?

25. Have you received any gifts, trips, rebates, etc. from wholesale distributors? If so, how is it reported?

26. Do you contribute obsolete inventory to charity? If so, how is the value of the items donated determined?

## EXAM LOCATION AND BUSINESS TOUR

While touring the taxpayer's business, the examiner should:

1. Observe the daily transactions to determine internal controls,
2. Look for consignment sales and understand how they are accounted for in the books,
3. Observe the number of registers running,
4. Look to see if the taxpayer is leasing booth space to clients and determine how much is charged for the space.
5. Verify that the items being sold in the store are being reported in the books.
6. Look for potential rebate items, such as displays and verify if it is being properly reported.

## BOOKS AND RECORDS

- IRM 321.5
- SAIN Guidelines should be followed when reviewing the books and records.
- Sales Records

1. Most large retailers have a system in place, which records the sale at the cash register as it occurs. In many cases the cash register is a computer terminal from which data is directly entered into the computer. This automated retail system is known as a point of sale (POS) inventory system.

2. These electronic cash registers accumulate various sales data. They identify the type of transaction, the method of payment (including credit card types and numbers), authorization codes and employee codes. Sales detail by product, department, store, day, and time is immediately available to management personnel using these sophisticated systems. It is important to get an understanding of the cash register receipts from the taxpayer, and verify if they are consecutively numbered.

## RESOURCES

Utilize whatever resources are available to learn more about the market segment and to complete the examination in a timely manner. Some of the resources that are available are:

1. National Market Segment Specialization Program Facilitator
2. District Market Segment Specialization Program Coordinator
3. Issue Specialist
4. Project Coordinator
5. Computer Audit Specialist
6. Internet
7. Newspaper and trade journal articles
8. Other ATGs and reference material (Internal Revenue Service publications, periodicals, etc.).

## Personal Expenses IRM 468

Gift shop owners may improperly pay and deduct expenses that do not relate to the operation of the business or may withdraw merchandise from the business for their personal use. Question the taxpayer concerning personal purchases and withdrawals. Review cost of sales, purchases, journal entries, and adjusting journal entries. Be aware of credit card purchases and travel expenses.

## BALANCE SHEET LIABILITIES

**Balance Sheet Accounts**. Timing of income can be a source of material adjustments. Examiners should be alert to the existence of balance sheet accounts, both asset and liability, with growing credit balances. The credit balance may represent income, which is being improperly deferred.

**Deferred Income Accounts ─** Because the income from gift certificates must be reported no later than it is for book purposes, it is not likely that the examiner will see this on the Schedule M. The examiner is more likely to find this issue on the balance sheet as a liability identified as gift certificates, customer credits or customer deposits. In addition to requesting an explanation or written documentation of their gift certificate issuance and record keeping procedures, the examiner should request samples of the certificates. Most will bear a serial number that will aid in determining how long the certificates have been outstanding. The taxpayer should also have some internal controls to prevent employees from abusing the gift certificates and to prevent counterfeiting. The examiner should get descriptions of these procedures and/or manuals as well as any internal audit or security reports dealing with gift certificates.

**Deferral Beyond Second Year** - The most likely situation that will be encountered is where the retail gift shop is deferring the recognition beyond the second year following the receipt of the cash. This might occur due to poor record keeping where no tracking of the outstanding gift certificates is made. However it should be noted that Treas. Reg. section 1.451-5(d) requires the taxpayer to file an information schedule with its return that shows (a) the total amount of advanced payments received in the taxable year; (b) the total amount of advanced payments received in prior years that were included in gross receipts of the current year; and (c) the total amount of advanced payments received in prior years that have yet to be included in income. Thus in order to defer the income in the first place, the taxpayer must maintain some basic records.

## VENDOR REBATES AND ALLOWANCES

Ask the taxpayer to explain the various types of allowances and rebates that they negotiate. Consider interviewing buyers or other appropriate personnel who have first hand knowledge of vendor allowances and rebates (in compliance with third party contact provisions). Ask how the taxpayer accounts for these allowances for book as well as for tax purposes. What accounts are used and what are the accounting entries? How and by whom are they tracked throughout the year? Are they recorded when earned or when paid? What is the magnitude of these rebates? Approximately how many vendors are involved? Secure a list of vendors that offer rebates to the taxpayer.

Review the accounts into which the allowances are entered. Do these entries relate in size and timeliness to the information secured? Request selected vendor contracts or agreements as well as computation workpapers. If appropriate, consider a review of any large allowances reported in the first months of the year to determine if, as of year-end, similar monies have been properly accrued or improperly deferred.

## POTENTIAL UNREPORTED INCOME

Another area to consider in relation to service departments is how the taxpayer treats rebates and allowances (R&A) in its cost of sales calculation. Many taxpayers have treated R&A as a cost of sales for book purposes, and as a period cost for tax. The Service contends that both income and expense should be treated as part of the cost of sales calculation. The Tax Reform Act of 1986 (TRA 1986) legislatively removed IRC section 453A. Prior to its removal, this section allowed substantial deferral of gross profit since the amount of deferred income was directly affected by the gross profit percentage. The issue was addressed in ***Marcor, Inc. v. Commissioner***, 89 TC 181 (1987), ***nonacq.***, 1990-2 C.B. 1., where it was decided that service department cost was not an item which should be included in cost of sales, however the Commissioner non-acquiesced.

## INTERNAL CONTROLS

A large portion of retail gift shop sales are in cash, therefore, it is important to evaluate internal controls when examining retail gift shops. As a general rule, the larger and more decentralized the retail gift shop, the better the internal controls will be. It is to the owners' benefit to install effective internal controls over all facets of the business whenever the owner cannot oversee these details personally, to avoid losses due to error, embezzlement, and theft by employees. Good internal controls will free the examiner to thoroughly review the accounting system, rather than test the accuracy of individual transactions.

# Chapter 4
# Supporting Law

## CASE LAW – MISCELLANEOUS ISSUES

Taxpayers operating gift shops have been involved in a vast array of issues litigated with the government. Issues litigated include:

1. Tax evasion (use of the net worth method) US-CT-APP-2, **[63-2 USTC ¶9517], United States of America, Appellee v. Gerald A. Guidarelli, a/k/a Gerardo A. Quindarelli, Defendant-Appellant** , (June 04, 1963)

2. Income (constructive receipt), dividends, method of accounting US-CT-APP-6, **[92-1 USTC ¶50,141], William S. Hagaman, Petitioner-Appellant, Bonnie C. Hagaman, Petitioner v. Commissioner of Internal Revenue, Respondent-Appellee** (Mar. 06, 1992)

3. Gross income (reconstruction, use of Bank Deposits Methods) & Civil penalties **Joseph and Annie Chu v. Commissioner**, Docket Nos. 142-95, 22884-95., TC Memo. 1996-549, 72 TCM 1519, Filed December 18, 1996

4. Accounting methods, income **- Robert M. Salladay and Patricia J. Salladay v. Commissioner**, (Feb. 26, 1985) Docket No. 16598-81, 49 TCM 827, TC Memo. 1985-86

5. Net operating loss, stock worthlessness – **Herbert T. Jones and Magdalene S. Jones v. Commissioner**, (Oct. 25, 1973) Docket No. 2685-72, 32 TCM 1115, TC Memo. 1973-238

6. Sale and leaseback of property - **Archie P. Sherar and Terry A. Sherar, Appellants v. United States of America, Appellee** , (June 24, 1969) (CA-9), U. S. Court of Appeals, 9th Circuit, No. 22,910, 413 F2d 986, Affirming an unreported District Court decision

**Many other Federal income tax issues involving gift shops have been resolved through the civil and criminal judicial process throughout the years. Although we have not listed all of them in this ATG due to the volume, most if not all can be found with tax research software using "gift shop" as a keyword.**

## METHOD OF ACCOUNTING

- IRC section 446. GENERAL RULE FOR METHODS OF ACCOUNTING
- Treas. Reg. section 1.446-1(c)(2)(i)
- Treas. Reg. section 1.471-8(c)
- Treas. Reg. section 1.471-1
- Treas. Reg. section 1.471-8(a) or (d).
- ***Boynton v. Pedrick***, [56-1 USTC ¶9126] and , 228 F. 2d 745 (2nd Cir. 1955), ***cert. denied***., emphasizes the accrual basis requirement when inventories are a part of the business. The case states: "* * * the power of the Commissioner to require the use of inventories in computing income carries with it the power to require the use of a method of accounting in which the use of inventories has substance and meaning."
- ***Wilkinson-Beane, Inc. v. Commissioner***, TCM, [CCH Dec. 29,546(M)] Docket No. 2325-67, 28 TCM 450, TC Memo. 1969-79, Filed April 21, 1969 420 (1st Cir. 1970), (caskets are merchandise because they played a central role in the sale of the taxpayer's funeral services);
- ***Knight-Rider Newspapers, Inc. v. United States***, (newspapers sold to the public are merchandise). [84-2 USTC ¶9827], 743 F.2d 781, 797 (11th Cir. 1984)
- Revenue Procedures 97-27, 97-37 and 99-49

## CONTRIBUTIONS OF INVENTORY

- IRC section 170(e)(1).
- IRC section 170(e)(3)(A).
- Treas. Reg. section 1.170A-(1)(c )(3)
- Treas. Reg. section 1.170A-4A

## INCOME ISSUES

- Rev. Rul. 74-607, 1974-2 C.B. 149
- IRC section 6110(j)(3).
- Treas. Reg.section 1.451-5(e) deferral of income – change of accounting requirement

- Treas. Reg. section 1.451-5
- IRC section 451.

## CONSIGNMENT GOODS

- IRC section 471. General Rule for Inventories
- Final Treas. Reg. section 1.471-1
- IRC section 451. GENERAL YEAR FOR TAXABLE YEAR OF INCLUSION
- Rev Rul 72-465, 1972-2 CB 233
- ***Max Buchman v. Commissioner***, Reconstruction of income: Increase in net worth. --, (Jan. 18, 1954) Docket Nos, 36849, 36851, 13 TCM 29]
- ***Ralph B. Bates v. Commissioner***, *Held:* 1. [Penalties: Fraud: Proof.]--, (Jan. 19, 1956) Docket Nos. 51979, 51980, 15 TCM 47, TC Memo. 1956-12
- ***Cleo Perfume, Inc. v. Commissioner***, Gross income: Discharge of indebtedness: Debtor relationship: Merchandise on consignment. --, (Apr. 27, 1998) Docket No. 26008-96., TC Memo. 1998-155, 75 TCM 2200
- ***Record Wide Distributors, Inc., Appellant v. Commissioner of Internal Revenue, Appellee*, Accounting methods: Accrual basis: Bad debts: Proof.--**, (July 14, 1982) (CA-8), U. S. Court of Appeals, 8th Circuit, No. 81-1853, 682 F2d 204, Affirming Tax Court, 41 TCM 704, CCH Dec. 37,615(M), TC Memo. 1981-12

## AMORTIZATION OF FRANCHISES AND TRADEMARKS

- IRC section 197

Intangible Property These provisions were added to the Internal Revenue Code of 1986 by Section 13261 of OBRA 93 to apply to intangible property acquired after August 10, 1993, or after July 25, 1991, if a valid retroactive election to apply OBRA 93 to intangibles has been made on a timely filed return.

# Chapter 5
Additional Information

## EXCISE ISSUES

A retailer may be liable for excise tax on its sale of certain articles of sports fishing equipment and archery equipment if it imports the articles in the United States. IRC section 4161(a) imposes a tax on the sale of articles of sport fishing equipment specifically enumerated in IRC section 4162, including any parts or accessories of the article sold on or in connection therewith or with the sale thereof. IRC section 4161(b) imposes a tax on bows, certain bow parts and accessories, certain quivers, and certain arrow components.

## EMPLOYMENT TAX ISSUES/ INFORMATION RETURNS

Consideration should be given as to whether "contract labor" or fringe benefits are taxable to the recipient. Some businesses set up temporary stores in various locations and utilize individuals who are regular employees to set these stores up. The payments may be classified as other expense, set up expense, contract labor, travel, etc. but if the services are performed by employees, this compensation should be included in the Form W-2 wages. If the payments are, in fact, to independent contractors who come in and set up the store, verify that Form 1099 has been issued if required.

If an employment tax issue is raised, Section 530 and CSP must be considered.

## COMPLIANCE

As in any examination, be alert for areas of non-compliance: follow proper internal procedures for referral.

# Glossary

**Advertising allowance:** A discount in price or payment given to a store to help meet the expenses of the store's advertising of a product.

**Additional markup**: The increase in the original retail price of merchandise because of errors in the original pricing or to increases in their value within the market.

**Average inventory of item**: That amount representing a midpoint between the highest and lowest inventory levels.

**Back order**: Merchandise ordered but not available for delivery because the supplier does not have it in inventory.

**Bar code**: A series of vertical or horizontal parallel lines forming a code that is optically read and interpreted by a bar code scanner**.**

**Bargain section**: An area in the store set aside for the sale of discounted ---usually seasonal merchandise**.**

**Bonus goods**: Merchandise given without extra charge by a manufacturer to a retailer who agrees to purchase a minimum quantity of units in a special deal.

**Co-operative advertising**: An arrangement between the manufacturer and the retailer where the manufacturer reimburses the retailer in part or in full for advertising costs.

**Charge back**: The retailer's invoice for claims against a vendor resulting from items such as damaged merchandise, cooperative advertising costs, and other costs.

**Consignment sale**: An agreement where the gift shop owner takes possession of goods. However, title remains with
the owner or vendor. Unsold items can be returned following an elapsed time period.

**Franchisee**: A retail establishment that purchases the right to market the goods or services of a franchisor in exchange for the use of the latter's name, product line, or service

**Franchisor**: A manufacturer, wholesaler, or serve distributor that sells the right to use its name, advertising, management and marketing expertise to retail establishments for a fee.

**Gift Association of America (GAA):** Located in New York City, an association of retailers, and wholesalers of gifts, china, glass, and decorative accessories. Formerly the Gift and Decorative Accessories Association.

**Gift certificate:** A purchased certificate written in any dollar amount and given as a gift that is redeemable in goods at the store of purchase.

**Initial mark-on:** The difference between the retail value of goods and the delivered costs when they are first placed on display.

**Initial mark-up percent**: The difference between the cost of goods and the price at which it sells converted to a percentage figure and expressed on a storewide basis.

**Initial retail price:** The cost of merchandise plus the amount of initial mark-up.

**Inventory shrinkage**: Inventory reduced by theft, internal or external fraud, waste, sabotage, or careless operation.

**Inventory turnover:** The number of times, on the average, that inventory is replaced during a period. It is calculated by dividing cost of goods sold by average inventory.

**Invisible shrinkage**: Stock shortages due to shoplifting, employee theft, losses due to clerical error, etc. which are undiscovered until a physical inventory is made.

**Layaway plan**: A method of deferring payments whereby goods are retained by the store until the customer has completed payments for them.

**LIFO (last in-first out**): In valuation of inventories, the system whereby the price shown on the last incoming shipment of a particular item is the one used for current valuation and cost.

**Markdown participation**: Vendors agree to reimburse all or a portion of product markdowns taken on a specific product, in order to instill confidence in the buyer that the product will perform as predicted.

**National Retail Federation (NRF):** Based in New York City, formed by the merger on January 17, 1990, of the American Retail Federation and the National Retail Merchants Association, NRF represents employers of nearly 20 million Americans, employing 1 in 5 workers in the country.

**Peak season:** The time of the year when a retail gift shop does its greatest volume of sales, usually the weeks before Christmas.

**Rebate:** Any deduction made from a payment or charge. In contrast to a discount, a rebate is not deducted in advance, but is returned to the customer following payment of the full amount.

**Retail method of accounting for inventory**: A method used to average inventory. It uses the relationship of retail price to cost to determine the cost of merchandise in inventory.

**Seasonal merchandise**: Items so closely identified with a specific season or holiday that they have a very short sales life.

**Slotting allowance**: Payment by vendor to have their merchandise displayed in a specified desirable store location.

**Target profit percentage**:  The desired percentage over cost that merchandise can be sold over retail.

**Trade show**:  Where manufacturers and wholesalers of gift items meet for the purpose of showing their merchandise.

**Volume discount:**  A reduced charge for quantity or multiple purchases.